NOTTINGHAMSHIRE
Fire & Rescue Service
Creating Safer Communities

Nottinghamshire and City of Nottingham
Fire and Rescue Authority

PRUDENTIAL CODE FOR CAPITAL FINANCE 2021/22

Joint Report of the Treasurer to the Fire Authority
and Chief Fire Officer

Date: 26 February 2021

Purpose of Report:

To inform Members of the Authority's obligations under the CIPFA Prudential Code for Capital Finance.

To seek the approval of Members to the proposed capital plans, prudential limits, and monitoring processes set out in the report.

Recommendations:

That Members approve the Prudential Limits for 2021/22 (see Section 10 for details).

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1. BACKGROUND

1.1 The Local Government Act 2003 set out a framework for the financing of capital investments in local authorities which came into operation from April 2004. Alongside this, the Prudential Code was developed by the Chartered Institute of Public Finance and Accountancy (CIPFA) as a professional code of practice to support local authorities' decision making in the areas of capital investment and financing. Authorities are required by regulation to have regard to the Prudential Code.

1.2 CIPFA released an updated version of the Prudential Code in December 2017. The revised code includes a requirement for authorities to produce a Capital Strategy. The 2021/22 Capital Strategy formed part of the Medium Term Financial Strategy which was approved by Fire Authority on 27 November 2020.

1.3 The objectives of the Prudential Code are to ensure that the capital investment plans of authorities are affordable, prudent and sustainable and that treasury management decisions are taken in accordance with good professional practice. In exceptional cases, the Code should provide a framework which will demonstrate where the objectives may not be ensured, so that timely remedial action can be taken.

1.4 The Prudential Code sets out a number of indicators which authorities must use to support decision making. These are not designed to be comparative performance indicators. In addition, the CIPFA Treasury Management Code of Practice and guidance notes sets out a series of treasury indicators. The prudential and treasury indicators should be considered in parallel and they are therefore included together in this report.

1.5 In addition to the indicators that are required by the Prudential Code and the Treasury Management Code of Practice, this report proposes the adoption of a local indicator for internal borrowing and investment benchmarks which will help the Authority to more effectively manage the risks involved with certain elements of treasury management activity.

1.6 This report sets out the proposed prudential and treasury limits for the Authority for the 2021/22 financial year along with the implications of the proposed Capital Programme, which will be presented with the budget report also on the agenda.

1.7 Reports which monitor the Authority's performance against these indicators will be presented to the Finance and Resources Committee throughout the year.

2. REPORT

PRUDENTIAL INDICATORS FOR AFFORDABILITY

2.1 Estimates of the Ratio of Financing Costs to Net Revenue Stream

	2019/20 Actual £000s	2020/21 Estimate £000s	2021/22 Estimate £000s	2022/23 Estimate £000s	2023/24 Estimate £000s	2024/25 Estimate £000s
Total Revenue Costs	2,252	2,487	2,499	2,787	3,196	3,468
Net Revenue Stream	44,746	46,729	46,217	47,485	48,747	50,047
	Ratio of Financing Costs to Net Revenue Stream					
Ratio	5.0%	5.3%	5.4%	5.9%	6.6%	6.9%

2.2 On 24 October 2008 the Finance and Resources Committee set a maximum limit of 8% for this ratio in order to meet the Prudential Code requirements of affordability and sustainability (as part of the Sustainable Capital Plans report). This is periodically reviewed by Treasury staff and it is still felt to be appropriate. This ratio is expected to rise over the coming years from 5.0% in 2019/20 to 6.9% in 2024/25. Financing costs include minimum revenue provision (MRP) costs, plus interest payable and interest receivable. The MRP cost is driven by the level of capital expenditure in the previous financial year and the useful life of the assets purchased. Financing costs are expected to increase year-on-year to reflect the increase in borrowing required to fund the ongoing capital programme (see section 2.4). The net revenue stream (comprised of council tax, national domestic rates and non-specific government grants) is expected to increase at a slower rate, hence the increase in the ratio.

2.3 The estimated ratios for 2021/22 onwards assume an annual council tax increase of 1.95%.

PRUDENTIAL INDICATORS FOR CAPITAL EXPENDITURE AND EXTERNAL DEBT

2.4 Estimate of Total Capital Expenditure

	2019/20 Actual £000s	2020/21 Estimate £000s	2021/22 Estimate £000s	2022/23 Estimate £000s	2023/24 Estimate £000s	2024/25 Estimate £000s
Capital Expenditure	**1,858**	**4,107**	**5,835**	**5,251**	**4,666**	**5,631**
Funded by:						
Borrowing	280	1,751	4,201	2,372	2,513	2,790
Revenue / Reserves	22	162	0	0	0	0
MRP Re-investment	1,541	1,674	1,624	1,869	2,143	2,481
Capital Grant	0	0	0	0	0	0
Capital Receipts	15	520	10	1,010	10	360
Total	**1,843**	**4,107**	**5,835**	**5,251**	**4,666**	**5,631**

2.5 The estimates for 2021/22 to 2024/25 form part of the budget report on this agenda

2.6 The Capital Programme is funded from a mixture of borrowing, capital receipts and reserves. This combination will be reviewed on an ongoing basis to ensure the best long-term options are achieved for the Authority. This will include consideration of borrowing rates, reserve levels and revenue and capital receipt availability.

2.7 “MRP re-investment” in the above table refers to the use of the minimum revenue provision which is used to reduce the borrowing need rather than for the repayment of debt due to the Authority’s loans being payable on maturity. “Borrowing” refers to the shortfall in funding after other funding sources have been applied. This borrowing may not necessarily take place externally. The Authority may judge it prudent to make use of the cash that it has already invested for long-term purposes. In doing this, the Authority does not reduce the magnitude of the funds it is holding for these long-term purposes but simply adopts an efficient and effective treasury management strategy. This practice, known as “internal borrowing”, is common in local authorities and means there is no immediate link between the need to borrow for capital spending and the level of external borrowing.

2.8 **Capital Financing Requirement**

31/03/20 Actual £000s	2020/21 Estimate £000s	2021/22 Estimate £000s	2022/23 Estimate £000s	2023/24 Estimate £000s	2024/25 Estimate £000s
Capital Financing Requirement					
26,019	27,770	31,971	34,343	36,856	39,646

2.9 The Capital Financing Requirement is the amount required from external sources to fund Capital Expenditure and represents the Authority's underlying need to borrow for capital purposes. It will therefore be the aggregate of all capital expenditure, less any revenue contributions, capital grants or capital receipts. The above table shows that the Capital Financing Requirement increases year on year between 2019/20 and 2024/25 as annual capital expenditure exceeds the funding available from capital receipts, government grants and revenue sources.

2.10 The Sustainable Capital Plans report referred to in paragraph 2.2 also concluded that in order to meet the Prudential Code requirements of affordability and sustainability, the capital financing requirement in future years should not exceed £40m. Based on current estimates the capital financing requirement will remain within this limit within the medium term, although it is approaching £40m by the end of 2024/25. A review of this indicator is underway with the Authority's treasury advisors to explore ways to avoid a potential future breach beyond 2024/25. The service's Fire Cover Review is due to be undertaken shortly and this may provide opportunity for reducing capital investment or reviewing the timing of the programme. Other options include using revenue or reserves to fund some capital expenditure or to repay debt if required.

Operational Boundary and Authorised Limit for External Debt

2.11 The Operational Boundary is the Authority's estimate of its total external debt, including other long-term liabilities (such as finance leases) which are separately identified. This is to reflect the most likely scenario and not the worst case. It is possible for the operational boundary to be temporarily breached to take account of unusual movements in cash flow, but this should not be a regular occurrence. A variation from the operational boundary is permissible but will be reported to the Fire Authority.

2.12 The operational boundary includes allowances to borrow to fund the capital programme, replace maturing debt and to allow for any short term borrowing that may be needed to cover the cashflow of the authority.

2.13 The Authorised Limit is essentially the same as the Operational Boundary but allows headroom over and above it to take account of unusual movements in cash flow and therefore should be the maximum amount of external debt that the Authority is exposed to at any given time. Any proposed variation from the Authorised Limit must be authorised by the Fire Authority.

2.14 **Operational Boundary and Authorised Limit**

	2020/21 £000s	**2021/22 £000s**	**2022/23 £000s**	**2023/24 £000s**	**2024/25 £000s**
Operational Boundary					
Borrowing	31,850	33,959	36,307	41,801	41,301
Other long-term liabilities	0	0	100	100	100
Total External Debt	31,850	33,959	36,407	41,901	41,401
Authorised Limit					
Borrowing	34,035	37,255	39,948	45,991	45,441
Other long-term liabilities	1,000	1,000	1,000	1,000	1,000
Total External Debt	34,035	38,255	40,948	46,991	46,441

2.15. The new leasing standard *IFRS 16 Leases* will be incorporated into the CIPFA Code of Practice on Local Authority Accounting with effect from 1 April 2022*.* IFRS 16 removes the operating lease categorisation for lessees. With the exception of short-term leases and leases of low value assets, a lessee will be required to recognise a right of use asset and an associated lease liability. This effectively moves all material long-term leases “on balance sheet”. The potential impact of this requirement on the prudential indicators is unknown at this point, but it is not expected to be significant. If necessary, the indicators will be reviewed, and any required changes will be reported to members.

2.16 **Actual External Debt as at 31/03/20**

	2019/20 £000s
Actual borrowing	28,512
Actual other long-term liabilities	0
Total – Actual External Debt	**28,512**
Operational Boundary	30,600
Authorised Limit	33,660

PRUDENTIAL INDICATORS FOR PRUDENCE

Gross Debt and the Capital Financing Requirement

2.17 In order to ensure that over the medium term gross debt will only be for capital purposes, this indicator requires that external debt does not, except in the short term, exceed the total of the capital financing requirement (CFR) in the preceding year plus the estimates of any additional CFR for the three subsequent financial years. Performance against this indicator will be monitored throughout the year. At the end of 2024/25, Gross Debt is expected to be in the region of £39m, with the Capital Financing Requirement estimated at £40m. This shows that this indicator is realistic.

INDICATORS FOR TREASURY MANAGEMENT

2.18 The Service carries out its own treasury management in accordance with the CIPFA Code of Practice for Treasury Management, which was revised in 2017. The Authority has adopted a low risk approach to treasury management, which seeks to ensure that investments are secure and that there is sufficient liquidity of funds to enable the Authority to carry out its business.

Gross and Net Debt

2.19 The actual amount of external long term borrowing as at 31 March 20 was £26,958k, with short term borrowing totalling £1,554k. There were no other long-term liabilities at the same date. At the same date, the amount of investments was £10,647k, giving a net debt position of £17,865k.

2.20 The Treasury Management Strategy 2021/22 report, also on this agenda, outlines the proposal to borrow over the next three years to finance the capital programme and to replace maturing loans. The decision about when to borrow will depend upon interest rate forecasts. For the purposes of setting indicators, assumptions have been made about when borrowing may take place – the reality of this will be determined by Officers in conjunction with the Authority’s treasury advisers.

2.21 The proportion of net debt to gross debt can highlight where an Authority is borrowing in advance of need, as it shows the extent to which funds have been borrowed and then invested. Whilst the Authority is permitted to borrow in advance to finance the capital programme, where borrowing rates are higher than investment rates this creates a “cost of carry”. Therefore, when investment interest rates are low, as they currently are, this cost is reduced by keeping the proportion of net debt to gross debt as high as is practicable. For information, the proportion of net debt to gross debt as at 31 March 2020 was 63%, and it is forecast to be 73% at the end of the current financial year. It is proposed that the Authority sets the following limits for the proportion of net debt to gross debt:

2.22 **Proportion of Net to Gross Debt**

	2021/22	2022/23	2023/24	2024/25
Lower limit for proportion of net debt to gross debt	50%	50%	50%	50%
Upper limit for proportion of net debt to gross debt	85%	85%	85%	85%

Interest Rate Risk Exposure

2.23 In terms of borrowing, it has been considered prudent to use Public Works Loans Board (PWLB) fixed interest loans on most occasions. This is because the PWLB generally offers rates which cannot be obtained elsewhere in the marketplace. In October 2019 the PWLB announced an increase in the margin over gilt yields of 100 basis points on top of the previous margin of 80 basis points, which made their rates less attractive. However, following consultation the rates reverted back to gilt yields plus 80 basis points in November 2020. Unlike lending, borrowing is a low risk activity so future borrowing arrangements will be entered into on the basis of what is most advantageous for the Authority at the time. Any proposals to borrow from alternative sources to the PWLB will be discussed with the Authority's treasury advisors.

2.24 Borrowing in the past has been at fixed interest rates although variable rates are not ruled out should they be considered financially advantageous at the time of financing. A maximum limit of 30% of borrowing from variable rate sources is proposed.

2.25 The total value of lending is not expected to exceed £14m, which is likely to peak around July and August 2021. However, it is difficult to assess what the likely investment profile might be as this depends upon capital expenditure timings as well as the level of pension top up grant received from the Government, and the timing of borrowing. All investments are made in line with the Treasury Management Strategy.

2.26 **Limits for Interest Rate Exposures**

	Benchmark %	**2020/21 %**	**2021/22 %**	**2022/23 %**	**2023/24 %**	**2024/25 %**
Interest Rate Exposures						
Upper Limit for fixed rate exposures	100%	100%	100%	100%	100%	100%
Upper Limit for variable rate exposures	30%	30%	30%	30%	30%	30%

2.27 In addition to the upper limit for variable rate exposures in relation to external debt, the Authority has adopted a local indicator which sets a limit for the acceptable level of internal borrowing. This is because the use of internal borrowing exposes the Authority to interest rate risk, as there is a chance that cash balances may need to be replenished at a time when interest rates are higher. In this respect, internal borrowing is effectively variable rate debt. The level of internal borrowing is calculated as follows:

Capital Financing Requirement – External Borrowing = Internal Borrowing

2.28 At 31 March 2020 the Authority was over-borrowed by £2,493k, which means that the level of external borrowing exceeded the capital financing requirement. This over-borrowed position came as a result of the Authority opting to take additional external borrowing at the end of the financial year in order to take advantage of low PWLB rates and mitigate the cash flow risks created by the economic upheaval caused by the Coronavirus pandemic.

2.29 It is proposed that the Authority sets the following limits for internal borrowing:

	2021/22 %	2022/23 %	2023/24 %	2024/25 %
Upper Limit for internal borrowing as a % of the Capital Financing Requirement	20%	20%	20%	20%

Investment Benchmarking

2.30 The Treasury Management Strategy 2021/22, which is also on this agenda, sets out the following local benchmarks to assess the security, liquidity and yield of its investments:

- **Security:** a risk benchmark of **0.08%** historic default when compared to the whole investment portfolio.

- **Liquidity:** a “Weighted Average Life of investments” benchmark of **approximately 3 months**, with an upper limit of **0.40 years**.

- **Yield:** internal returns to be above a benchmark of the **3-month London Interbank Bid Rate (LIBID).**

2.31 Further details of these benchmarks can be found in the Treasury Management Strategy 2021/22.

Loan Maturity

2.32 The code of practice and CIPFA guidelines state that there should be no direct linkage between the assets financed and the term of loans taken out. Upper limits in terms of loan maturity are set to ensure that the Authority is not exposed to the risk of having to repay loans and then re-borrow in the short term when interest rates might be high.

2.33 It is recommended that the maturity structure limits remain unchanged for 2021/22. The Authority holds a loan of £4m which is structured as a “Lender Option Borrower Option” (LOBO) loan. Whilst the end date of the loan is March 2078 there are options every five years for the lender to revise the interest rate. The Authority may choose to repay the loan without penalty if the amended rate is not advantageous. The next opportunity for the revision of the interest rate is 7 March 2023. The limits for these years will be kept under review to reflect that the investment may mature on these dates. However, as the risk of the LOBO rate increasing during the medium term is low due to downward pressures on interest rates, the re-financing risk arising from the loan maturing within 5 years is currently considered to be low.

2.34 **Limits on the Maturity Structure of Borrowing**

	Upper Limit	Lower Limit
Under 12 months	20%	0%
12 months to 5 years	30%	0%
5 years to 10 years	75%	0%
10 years to 20 years	100%	0%
Over 20 years	100%	30%

Principal Sums Invested for Periods Longer than 365 Days

2.35 Investments arising from borrowing to support the capital programme are unlikely to exceed one year in duration, however for surplus cash which supports reserves it may be desirable to invest monies for a slightly longer period to achieve a level of certainty around interest receipts and perhaps beneficial interest rates. Such decisions will be influenced by market conditions at the time and the liquidity of funds will be of paramount importance. It is proposed that Officers should be able to invest monies for longer than a year if this appears to be an advantageous strategy, but that a maximum limit of £2m be applied to any such investments. This will contain the Authority's exposure to the possibility of loss arising from having to seek early repayment of investments.

2.36 **Principal Sums Invested for Periods Longer than 365 Days**

2021/22 £000s	2022/23 £000s	2023/24 £000s	2024/25 £000s
Prudential Limits for Principal Sums Invested for Periods Longer than 365 Days			
2,000	2,000	2,000	2,000

3. FINANCIAL IMPLICATIONS

The financial implications of this report are set out in full within the body of the report.

4. HUMAN RESOURCES AND LEARNING AND DEVELOPMENT IMPLICATIONS

There are no human resources or learning and development implications arising from this report.

5. EQUALITIES IMPLICATIONS

This is not a new policy or service, so no initial assessment has been completed. A previous assessment has shown that there are no specific equality impacts which arise directly from the Prudential Code.

6. CRIME AND DISORDER IMPLICATIONS

There are no specific crime and disorder implications which arise directly from this report.

7. LEGAL IMPLICATIONS

The Local Government Act 2003 imposes an obligation on the Authority to agree and monitor its prudential indicators.

8. RISK MANAGEMENT IMPLICATIONS

The risk exposures in this report relate primarily to three areas:

- The risk of over exposure of the Authority to interest rate fluctuations;
- The risk that the Authority has an unmanageable or unaffordable level of borrowing;
- The risk of tying up investments, thereby reducing liquidity and exposing the Authority to possible losses arising from early repayment of investments.

This paper serves to set out those risks and ensure that they are managed.

9. COLLABORATION IMPLICATIONS

There are no collaboration implications arising from this report.

10. RECOMMENDATIONS

That Members approve the Prudential Limits for 2021/22 as follows:

Maximum ratio of Financing Costs to Net Revenue Stream	8%
Estimated Ratio of Financing Costs to Net Revenue Stream	5.4%
Estimate of Total Capital Expenditure to be Incurred	£5,835,000
Estimate of Capital Financing Requirement	£31,971,000
Operational Boundary	£33,959,000
Authorised Limit	£38,255,000
Upper limit for fixed rate interest exposures	100%
Upper limit for variable rate interest exposures	30%
Loan Maturity:	Limits:
Under 12 months	Upper 20% Lower 0%
12 months to 5 years	Upper 30% Lower 0%
5 years to 10 years	Upper 75% Lower 0%
Over 10 years	Upper 100% Lower 0%
Over 20 years	Upper 100% Lower 30%
Upper Limit for Principal Sums Invested for Periods Longer than 365 Days	£2,000,000

That Members approve the following local indicators for 2021/22:

Upper limit for internal borrowing as a % of the Capital Financing Requirement	20%
Limit for proportion of net debt to gross debt	Upper 85% Lower 50%
Investment security benchmark: maximum historic default risk of investment portfolio	0.08%
Investment liquidity benchmark: maximum weighted average life of investment portfolio	0.40 years
Investment yield benchmark	Internal returns to be above 3-month LIBID rate

11. BACKGROUND PAPERS FOR INSPECTION (OTHER THAN PUBLISHED DOCUMENTS)

None.

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